

*United States Court of Appeals
for the Second Circuit*



**BRIEF FOR
APPELLANT**

76-5039

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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In the Matter of

REA HOLDING CORPORATION, : Docket No. 76-5039
THE EXPRESS COMPANY, INC.,

RE A EXPRESS, INC., f/k/a

RAIL EXPRESS, INC., f/k/a
Railway Express Agency, Inc.,

Railway Express Agency, Inc.,
REXCO SUPPLY CORPORATION.

Bankrupts, : :

MATTHEW E. MANNING, ANTHONY SATRIANO, :

DANIEL S. GILHULY, VINCENT PONTILLO,

WILLIAM R. WEGL, EDMUND F. NOVITSKI, ::

EDWARD J. COX, ANTHONY J. JANUZZI,

CHARLES F. McGOVERN and JAMES J. :
:

KILCOYNE, petitioning creditors,

V.

C. ORVIS SOWERWINE, Trustee
in Bankruptcy,

Appellee. : :

APPELLANTS' BRIEF

WISEHART, FRIOU & KOCH
150 East 42nd Street
Suite 420
New York, New York 10017
(212) 557-8800

Dated: New York, New York
December 23, 1976

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FOR THE SECOND CIRCUIT

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Appellants, : -x

v. : -x

C. ORVIS SOWERWINE, Trustee
in Bankruptcy, : -x

Appellee. : -x

APPELLANTS' BRIEF

Preliminary Statement

The unreported decision appealed from is by Honorable Lloyd F. MacMahon, S.D.N.Y., confirming a report of Bankruptcy Judge John J. Galgay. The decisions are to be found in Appellants' Appendix submitted herewith.

Statement of the Issues

The issues as stated in the Pre-Argument Statement filed with this Court on October 18, 1976, are as follows:

"(1) Whether a fair hearing was held or whether the nature of the hearing denied petitioners procedural due process.

(2) Whether the conflict of interest and disqualification issues had been raised so as to require resolution in context of hearing.

(3) Whether decision on the Chapter X petition was proper in view of (a) the unauthorized answer purportedly filed on behalf of the Debtor-in-Possession and (b) the request of counsel for the Debtor-in-Possession to withdraw.

(4) Whether the findings are clearly erroneous.

(5) Whether adequate notice of the hearing was given.

(6) Whether a valid determination could be made in the absence of any first meeting of creditors ever having been held following adjudication, particularly in view of the finding that 'the liquidation being conducted by this Trustee is the best method of preserving the remaining values for those entitled to share in such values.'

(7) Whether an independent determination of the values of the bankrupt estate was not required, in fairness to the creditors."

Statement of the Case

REAEMCO, Inc. (an acronym for "REA Employees' Company") was formed in order to acquire the stock of REA Express, Inc., in bankruptcy since November 6, 1975, for the REA employees so that they would own, and could continue to operate, the company under an Employees' Stock Ownership

Plan. The operational aspects of the plan were developed by Mr. F. Ralph Nogg, a leading transportation authority, who had succeeded in reorganizing Yale Express under Chapter X of the Bankruptcy Act. Mr. Nogg's services were requested by Robert J. Devlin, International Vice President, Express Division of the Brotherhood of Railway and Airline Clerks ("BRAC"), the labor organization representing most of REA's 8,000 employees who lost employment when REA was adjudicated a bankrupt.

On April 20, 1976, Mr. Nogg, Mr. Devlin, and C. Orvis Sowerwine, the Trustee in Bankruptcy for REA, in the presence of the Trustee's counsel had a general handshake all around under which it was understood that the REAEMCO proposal was accepted and approved by the Trustee for a cooperative working arrangement which would lead to a favorable presentation to the creditors and the Bankruptcy Court.

Within a very few days, however, this idyl appeared. The Trustee informed REAEMCO's representatives that he had another serious proposal which he would have to consider by a foreign transportation conglomerate, Alltrans International, U.S.A. ("Alltrans"). REAEMCO's representatives immediately took the position that this violated their agreement with the Trustee.

It is not disputed that the REAEMCO proposal was developed with the concurrence and approval of the Trustee; the Trustee made suggestions which were adopted in the formulation of the REAEMCO proposal; the Trustee requested substantial additional activities which were undertaken in the development of the REAEMCO proposal; and, on April 20, 1976, the Trustee, in the presence of his counsel, accepted the REAEMCO proposal for the purpose of jointly presenting and recommending it to the Bankruptcy Court and creditors. On April 20, 1976, it was agreed that the REAEMCO proposal would be put in final form for joint presentation to the Court with the Trustee's recommended approval. The approval of the creditors, according to bankruptcy counsel, would be a foregone conclusion. The technical objections which later surfaced, did so only when another proposal subsequently was presented. REAEMCO never took the position that a different proposal could not be presented to the Bankruptcy Court. However, REAEMCO felt that the Trustee had committed himself and his counsel to a cooperative working agreement to develop and present the REAEMCO proposal. Prior to such acceptance by the Trustee, he met and spoke with those who arranged for the initial capital financing, he discussed the manner in which the employee claims would be assigned, and participated in

deciding whether the proposal should take the form of a Chapter X reorganization proceeding or a sale of the stock of REA Express, Inc.

A hearing on these and other proposals was conducted by the Bankruptcy Court, which selected the Alltrans proposal on the basis of the Trustee's recommendation. In the process of the hearing, the Trustee took a partisan position, purporting to find technical difficulties with the REAEMCO where none had existed before.

In part to overcome these difficulties, and in part because Mr. Nogg had recommended a Chapter X reorganization from the beginning as the best way to preserve REA's substantial transportation rights, a Chapter X petition by some of the same former employees who supported the REAEMCO proposal, was submitted for filing as an alternative to the REAEMCO proposal in the hearing before the Bankruptcy Court.

All parties agree that REA's rights, if made permanent, would have a value in the range of \$50-\$100 million.

The Bankruptcy Court refused to entertain the Chapter X petition, and this constituted one of the grounds of appeal of the decision favoring Alltrans.

The appeal was argued before Henry F. Werker, U.S.D.J., who thereafter issued a memorandum stating:

"Since a Chapter 10 petition has apparently been filed in the above-captioned matter, the appeal of REAEMCO is no longer properly before me. For this reason, I am returning the Part I files to you.

As additional correspondence related to this appeal arrives in my chambers, I will forward it to you.

Thank you."

/s/ H.F.W.

The other issues involved in the appeal have not yet been decided, and we are informed by counsel for the Trustee that Judge Werker is awaiting disposition of the Chapter X petition. However, the record of the appeal before Judge Werker has been made a part of the record on this appeal.

The Chapter X petition originally was submitted to Judge Galgay on June 24, 1976 and treated by him as an exhibit in the hearing on the REAEMCO proposal. However, in some way, the petition became lost in the courthouse, and an alternative Chapter X was filed in substitution on September 22, 1976, upon the demand to do so by the Trustee's counsel and the suggestion of Judge Milton Pollack, to whom, as Part I Judge, the thorny issue of the apparent inconsistency between the local bankruptcy rules and the general Bankruptcy Rules promulgated of the Supreme Court in 1973 (after the adoption of the local rules) had been referred by Chief Judge Edelstein. Through

assignment by the "wheel," it went to Judge Lloyd F. MacMahon, who, in the midst of important criminal proceedings, remanded the matter to Judge Galgay of the Bankruptcy Court on September 27, 1976.

Judge Galgay conducted the entire hearing on the Chapter X petition in the afternoon of the same day, refusing to listen to any testimony from the three witnesses, including Mr. Nogg, offered on behalf of the petitioners. At the conclusion of the hearing on that day, Judge Galgay stated that his decision would be to dismiss the petition, and requested counsel for the Trustee to submit proposed findings on notice (Tr. September 27, 1976, p. 116).

The following day, this firm received the proposed findings after 6 p.m. Our objections were submitted to Judge Galgay at about 12:30 the next day, but by that time he had already signed his decision, and the objections were not considered. The hearing on the motion to confirm was before Judge MacMahon in the afternoon of the same day, before we had even seen the decision (Tr. September 29, 1976, p. 24).

The petition for the appointment of a receiver has a somewhat different procedural history than the Chapter X petition. Judge Werker's memorandum of September 15, 1976, stating that a Chapter X petition had "apparently" been filed, was quoted above. The petitioners had a desire to

protect the estate from the consequences of a change in administration, including application of the automatic stay provisions. Further, it was believed that the Trustee and his counsel had a disqualifying adverse interest in (a) opposing the Chapter X petition, and (b) in continuing to pursue a partisan position in the Interstate Commerce Commission in support of the Alltrans proposal while the alternative possibilities embraced by the REAEMCO proposal and the Chapter X petition were still pending on appeal.

The petition for the appointment of a receiver was addressed to these concerns. It was first submitted to Judge Galgay on September 10, 1976, and brought on by an order to show cause signed by him on September 15, 1976, the date of Judge Werker's memorandum.

At the hearing on the order to show cause on September 21, 1976, Judge Galgay directed us to seek further instructions from the District Court Part I Judge, in view of a possible conflict between the Supreme Court's Bankruptcy Rules and the local District Court Bankruptcy Rules on whether such a petition should be submitted initially to the Bankruptcy Judge assigned or to the District Court. In Judge Pollack's absence, we went to Chief Judge Edelstein, who suggested we go to the District Court Clerk's office for assignment of the matter to a District Judge.

We did so, with a separate order to show cause for the District Court. Over a hundred former employees had signed the petition. It was at that point that counsel for the Trustee insisted that we file a duplicate Chapter X petition because of the loss of the earlier one in the courthouse. It was in that way that the two petitions in effect became merged together in the same proceeding which, in the pressing circumstances involving Judges MacMahon and Galgay, we regard as most unfortunate because neither received a fair consideration, and the separate nature of the petition for the appointment of a receiver was never really considered, as is apparent from the opinions below.

The situation which the appointment of a receiver (as well as the Chapter X petition) was designed to protect against has occurred. On November 17, 1976, the Interstate Commerce Commission entered a Report and Order, a copy of which is submitted herewith, revoking most of REA's surface transportation authority. The basis of the revocation included findings which amount to incompetence and mismanagement on the part of the Trustee. Specifically, the Commission said "... there is nothing on this record to indicate that there is anyone capable of knowledgeable and responsible management of the purported motor carrier operations under REA's

authority"; "no one in the management of Rexco is familiar with the overall scope or limitation of REA's operating authority; no attempt is made to see that service is performed to and from authorized points ...; no attempt is made to see that drivers traverse authorized regular routes or to instruct them to use such routes; no responsibility is taken for control of drivers or shipments after pickup ..." etc., at length (pp. 18-19).

The Commission went on (p. 19):

"... In his disregard of the limitations of REA's authority, [the Trustee] may have jeopardized, rather than preserved, that asset. Here, we must conclude that the past Rexco Division operations have been in the nature of willful violations that cannot be considered to be of the type that could be evaluated as 'good faith' operations, 'under color of right' and thus given affirmative weight in the future purchase proceeding or any related matter."

The Commission concluded (p. 21):

"... the performance, under the apparent approval and direction of the Trustee in bankruptcy of the improper operations discussed above, shows that REA, as it now exists, is not fit to conduct proper and safe operations."

Meanwhile, although this decision of the ICC was in the offing, the Trustee moved precipitately to silence this firm's advocacy of the Chapter X petition. Even though an appeal had been taken to this Court, a temporary restraining

order was obtained on Sunday, October 24, 1976, without notice, and a preliminary injunction signed by Judge Galgay on February 4, 1976, was used by Trustee's counsel prejudicially in the pre-argument conference with Mr. Fensterstock on the same day.

The preliminary injunction has now been vacated by the United States District Court for the Southern District of New York in an order dated December 14, 1976, and the proceeding remanded for findings and conclusions to the Bankruptcy Court, where hearings are continuing. Petitioners regard this interference with their legal representation as a violation of an agreement entered into on their behalf in April 1976 by Mr. Nogg with the Trustee, and extensively relied upon thereafter, during which six-month period the proposals of the petitioners and those associated with them for the rehabilitation or reorganization of REA were actively litigated in the Bankruptcy and District Courts of the Southern District of New York through the filing of the appeal in the United States Court of Appeals for the Second Circuit. Only after this firm had already appealed the decision dismissing the petition for appointment of a receiver ad litem raising the issue of the Trustee's conflict of interest in opposing the proposed Chapter X reorganization and lack of balance in representing the interests of the bankrupt estate before

this Commission, and the separate petition for a Chapter X reorganization, did the Trustee seek to silence by injunction the firm's representation of the interests of the former employees. This was contrary to his agreement with Mr. Nogg, and made it almost impossible for the appeal to proceed. The injunction was requested essentially on the erroneous ground that disagreement with the personal views of the Trustee, who ignored Mr. Nogg's repeated recommendations favoring a Chapter X reorganization for REA, the merits of which disagreement can be resolved only by completion of the appellate process, constitutes a conflict with the interest of the bankrupt estate as such, in which interest the recommendation was in fact made.

Because of the foregoing circumstances, the pursuit of this appeal was seriously prejudiced and delayed at a most critical point. Indeed, the preliminary injunction was in effect when the Commission's order of November 17, 1976 was issued. The effect on this firm is not nearly as important, of course, as the effect upon the interests of thousands of unemployed persons to whom the litigation before this Court of the serious issues raised in this appeal are of the utmost urgency. They also have an important bearing upon the manner in which the bankruptcy laws are being administered in large bankruptcies, in which substantial public interest considerations are lost sight of.

See "Investigating the Collapse of W. T. Grant," from Business Week, July 19, 1976, pp. 60-62, which contains the following statements about the W. T. Grant bankruptcy proceeding before the same Bankruptcy Court, in which 80,000 people lost their jobs:

"Marvin E. Jacob, the SEC associate regional director, believes that, first of all, Grant should have been put into Chapter X proceedings, in which a disinterested court-appointed trustee works closely with the SEC in reorganizing a public company with a complicated debt structure. 'We will never know if Grant could have been saved because of the lack of disinterested trustees and a thorough investigation of the company,' Jacob says."

'The whole thing has been a horrible situation,' fumes the SEC's Jacob. 'Haste had been the watchword here. They took a big public company which should have been a Chapter X proceeding and ran it into the ground.'"

Scope of Brief

In this brief for the appellants, we have endeavored in the interest of both time and burden on the Court to avoid undue overlapping with respect to the brief which has been submitted on behalf of Intervenor Brotherhood of Railway & Airline Clerks. This brief therefore goes more into the facts, with which we have greater familiarity, and the merits of the conflict of interest issue, which is not covered in the Intervenor's brief.

ARGUMENT

I

APPELLANTS WERE
DEPRIVED OF A FAIR HEARING

The proceeding on the Chapter X petition can not be dignified by the word "hearing". F. Ralph Nogg, a noted transportation expert, having flown all night to be present, and having specially prepared testimony (Tr. September 29, 1976, p. 40), was not permitted to utter one syllable in the Bankruptcy Court. And if the further step through the District Court was supposed to correct any excesses or mistakes, it clearly was not so conducted.

The essential point to which Mr. Nogg would have testified, as shown in the offer of proof, is that the reorganization of REA would be feasible (Tr. September 27, 1976, p. 87), and that it would have the further great advantage of putting a different face on the critical proceedings before the ICC at an extremely critical time (Tr. September 27, 1976, p. 93).

The great tragedy resulting from the deaf ear turned by the courts below is reflected in the ICC's order of November 17.

However, a petition for rehearing has been filed on behalf of the employees. We continue to hope that the change in circumstances embodied in an objective consideration of the Chapter X alternative would cause the Commission

to approach the entire situation in a different light. This is so especially since it appears that the Commission had previously concluded that an attempt to reorganize REA under Chapter X of the Bankruptcy Act, rather than the liquidation approach being followed by the Trustee in straight bankruptcy, would be more likely to result in its continued operation. The Commission pointed out that under Chapter X, any plan of reorganization developed would be submitted to the Commission so that it might participate in its formulation in the Bankruptcy Court, a result it is believed would be highly desirable in the public interest. In a document entitled Report of REA Study Group prepared by the Commission's staff and transmitted with a letter from the Chairman dated June 26, 1972, to the Senate Surface Transportation Subcommittee, the following statement appears (Hearings, 92d Cong., 2d Sess., Serial No. 92-71, Part 3, p. 1338):

"A bankruptcy proceeding under the conventional provisions of the Bankruptcy Act ordinarily contemplates liquidation of the debtor. The court may direct that its assets be collected and that sale of its properties be made at public auction to high bidders, subject to the approval of the court and, if pertinent, regulatory authorities.

With Section 77 of the Bankruptcy Act having no applicability, the bankruptcy proceeding for REA would involve the largest carrier subject to this Commission's

regulation to have been involved in proceedings under Chapter X of the Bankruptcy Act. In that sense the bankruptcy proceeding would be without parallel. From general observance of bankruptcy proceedings as they have affected carriers by motor vehicle, a reorganization proceeding under Chapter X would more likely result in continued operations by REA as debtor than under conventional provisions of the Bankruptcy Act. Most often, when a motor carrier has gone into bankruptcy under the liquidation provisions of the Bankruptcy Act, its operations are either discontinued or drastically curtailed by order of the court. Except as mentioned immediately below, the Commission has no function under other provisions of the Bankruptcy Act comparable with Section 77 in the case of railroad reorganizations. The exceptions deal with Chapter X of the Bankruptcy Act, Section 177, which provides, in substance, that where the debtor is a public utility company and subject to regulatory jurisdiction of a commission, no plan of reorganization shall be approved until the plan has been submitted to each commission having regulatory jurisdiction. Each such commission shall have had an opportunity to suggest amendments or make objections to the plan, and the judge shall have considered such amendments or objections at a hearing before which the regulatory agency may be heard. Also the Commission would have potential jurisdiction under sections 5 or 20a-214 to pass on a two-carrier transaction or the issuance of securities." (Emphasis added.)

II

THE ISSUE OF A CONFLICT OF
INTEREST HAD BEEN SUFFICIENTLY RAISED

1. The Motion to Disqualify

During the hearing before the Bankruptcy Court on September 27, 1976, counsel for the Appellants herein moved under Rule 7(b) of the Federal Rules of Civil Procedure to disqualify the Trustee and his counsel from participating in the proceeding with respect to the good faith issue in the Chapter X petition. The principal grounds asserted for such motion are those set forth in the Appendix to Petitioner's Pre-Hearing Memorandum which was filed with the Bankruptcy Court on September 27, 1976, and which is part of the record before this court, namely: conflict of interest. And the further grounds were asserted for such motion that the Trustee and his counsel have a self interest and a personal interest in the matter so that they cannot be relied upon to adequately protect the interests of the creditors because their interest is to perpetuate their positions, whereas it is undisputed that the trustee lacks transportation experience and undoubtedly the change of the proceeding to a Chapter X proceeding would result in a change in the administration of the estate. Transcript of September 29, 1976 at 26, 40.

Counsel for appellants cited the decision of this court in Cinema 5, Ltd. v. Cinerama, Inc., 528 F.2d 1384 (2d Cir. 1976).

The Bankruptcy Court ruled that it was not going to entertain an oral motion, yet the extreme haste with which the Bankruptcy Court acted, indicating its decision that very day, shows that in no other way could the issue have possibly been raised for consideration in the context of the subject matter to which it directly related, namely, the filing of the Chapter X petition.

Transcript of September 27, 1976 at 40.

2. Portion of Issue is Covered in
Brief of Intervenor BRAC

The brief of intervenor BRAC covers at pages 14 to 16 the relevant provisions of law and Bankruptcy Rules relating to the application for appointment of a receiver and the related need to disqualify the trustee and his counsel. We will discuss other procedural aspects of the conflict of interest question and the relevant facts and law.

3. Additional Procedural Steps

Procedurally the motion to disqualify the trustee and his counsel from opposing the approval of the Chapter X petition on grounds of conflict of interest and on grounds of specific adverse interest in that they have a financial interest

in being perpetuated in office, does not rest solely upon the oral motion made at the hearing before the Bankruptcy Court on September 27, 1976. That motion was also made in written form and is contained in the document entitled "Opposition of Petitioning Creditors to Trustee's Proposed Findings of Fact and Conclusions of Law" dated September 29, 1976 and filed with the Bankruptcy Court and the District Court at about 12:30 p.m. on September 29, 1976. A copy of the memorandum was handed up to Judge MacMahon at the hearing held before him on September 29, 1976. Transcript of September 29, 1976 at 3. Neither the Bankruptcy Court nor the District Court, however, acted on the written motion which was contained in the memorandum in opposition dated September 29, 1976, although the Bankruptcy Court had been informed that papers would be filed that morning in opposition to the Trustee's proposed findings served on Appellants' counsel at 6:30 p.m. September 28, 1976.

Appellants submit that their procedural steps outlined above were adequate to cause the Bankruptcy Court to hear the conflict of interest question and rule on the motion to disqualify the trustee and his counsel.

However, procedurally there was far greater support, for disposition of the disqualification motion, than the oral

and written motions of September 27 and 29, 1976, as will be developed below.

Before we outline the substantial procedural steps which brought the conflict of interest question squarely before the Bankruptcy Court it may be helpful to explain how the question arose as to the trustee and his counsel.

Included in the Appendix to Petitioners' Pre-Hearing Memorandum is a letter dated May 6, 1976, from Robert E. Friou, a member of the firm of Wisehart, Friou & Koch, addressed to the trustee. The letter states that on April 13, 1976, the trustee had asked Mr. Friou to advise him concerning his possible conflict of interest in acting as trustee of REA Express, Inc. The facts were that the trustee is an officer and employee of Shearson Hayden Stone Inc., which has acted as a consultant to various railroads throughout the United States, and which continues to act and to seek to act in that capacity, including major current assignments.

The opinion letter dated May 6, 1976, also referred to the fact that the trustee had made the statement before third parties that "he believed that he had a conflict." Subsequently in testimony before the Bankruptcy Court the

trustee said that he did not say that he "believed that he had a conflict" but that "I said I had a conflict too." Transcript of December 15, 1976 at 99. The trustee also says "there has been a lot said about my having said I had a conflict, of course I said I had a conflict." Transcript of November 10, 1976 at 75. "I never to anyone ever said I had a serious conflict of interest. What I used perhaps inartistically the terms that I had a conflict. I didn't realize it was a word of art, when I said I had a conflict, I meant there were facts which created an apparent problem that had to be resolved." Transcript of November 10, 1976 at 83. And further: "I don't pretend to be an authority on the law of conflict of interest." Transcript of November 10, 1976 at 83.* These contentions are made notwithstanding the fact that the trustee is an experienced corporation lawyer, formerly a partner in a major New York law firm, and an investment banker; and had received from Mr. Wisehart a substantial memorandum dated February 18, 1976 detailing the conflicts of interest of his bankruptcy counsel, together with a copy of the Second Circuit's recent Cinema 5 decision, cited above. The improbability that a person of the

*The testimony that when the trustee reported his conflict of interest to Robert J. Devlin (Transcript of November 10, 1976 at 30) and to F. Ralph Nogg (Transcript of November 10, 1976 at 58) the trustee told those persons that his counsel had told him he did not have a conflict but he disagreed with counsel - indicating thereby that he did know that "conflict of interest" are words of art.

trustee's background and experience not knowing that "conflict of interest" is a "word of art" -- after he had recently studied the same question as it pertained to his bankruptcy counsel -- is readily apparent, and the contention should be treated with the scepticism it deserves.

The February 18, 1976 memorandum (WFK Exhibit 13 in evidence, Transcript of December 16, 1976 at 23) is a partial description of the professional involvement with railroads of the firms of Whitman & Ransom and Marcus & Angel who are co-bankruptcy counsel to the trustee. After the memorandum was prepared it was received by Professor S. Chesterfield Oppenheim because he had been retained as special counsel to the bankrupt estate in connection with the major litigation by REA against the railroads. Professor Oppenheim had completely approved the memorandum and it was then given to the trustee.

On May 11, 1976, Mr. Friou submitted to the trustee a second opinion letter which discussed some points raised by the trustee in commenting upon the conflict of interest issue raised in Mr. Friou's letter of May 6, 1976. The May 11, 1976 letter pointed out the facts relevant to the qualification of the trustee were not only the Shearson railroad work but also: (a) domination of the creditors

committee by railroads and airlines, (b) millions of dollars of claims by railroads and airlines against the bankrupt, (c) major litigation by REA against the railroads, (d) substantial REA claims against airlines, and (e) the substantial competition between REA and railroads and airlines for transportation business.

Mr. Friou's opinion of May 6, 1976, stated, on the facts already disclosed, "we think it must be assumed that a substantial possibility exists that, if the issue were raised, it would be decided that a conflict does exist", and that "full disclosure to all creditors and others who might be affected by your decisions is an immediate requirement." The opinion also recommended resignation rather than exposure to the personal risks entailed.

With the foregoing brief summary of the raising of the conflict of interest question we now outline the procedural steps by which the problem was brought before the Bankruptcy Court many times:

a. The conflict of interest of the trustee was, according to disputed testimony, mentioned to the Bankruptcy Judge in an off-the-record conference on March 9, 1976, when, the

trustee testified, he said he "had a conflict too" (the word "too" referring to the conflict of interest of his counsel). Transcript of November 10, 1976 at 79.

b. The trustee now testifies that on March 9, 1976, he distinctly remembers Judge Galgay saying, off-the-record, that "he did not feel that I had any problem but if I still felt I did I should take it up with my counsel." Transcript of December 15, 1976 at 50. Whether the Judge did so state is disputed and the Judge has not yet either (a) testified nor (b) disqualified himself pursuant to 26 U.S.C. § 455 as a material witness.

c. The trustee brought the conflict of interest question to the attention of the court by letter dated May 17, 1976, admittedly not served on this firm until August 23, 1976. Many of the statements made by the trustee are disputed as being inaccurate or misleading, as shown in affidavit of Mr. Friou, dated August 23, 1976, Document No. 7 in Appendix to Petitioners' Pre-Hearing Memorandum.

d. The trustee moved before the Bankruptcy Court on May 26, 1976, for authority to retain Windels & Marx, a law firm, "...in connection with rendering an opinion letter to the trustee and the Court with respect to a charge of conflict of interest...."

e. Appellants' counsel, Wisehart, Friou & Koch having been served with the motion to retain Windels & Marx, opposed the motion by filing a "Memorandum in Response to Motion" dated June 14, 1976. Appendix to Petitioners' Pre-Hearing Memorandum, Document 6. The Memorandum asked the Bankruptcy Court to deny the motion and to determine the conflict of interest issue itself on notice to all creditors, or to assign the issue to a United States Magistrate for findings and initial decision. The memorandum said in part:

"Because of the disputed nature of this issue, the importance of the interests involved, and in fairness to all concerned, the necessary factual determinations should be made on the record by this Court with notice to all creditors."

The outcome of the hearing requested by Wisehart, Friou & Koch in its memorandum dated June 14, 1976, would have been either an order of the court to remove

the trustee or an order of the court to confirm his continuation in office. Procedurally, we submit, that application was in substance and in form an application pursuant to Bankruptcy Rule 221(a).

f. The Windels & Marx retainer motion was decided from the bench on June 16, 1976. On June 21, 1976, Wisehart, Friou & Koch received in the mail an undated "Reply Memorandum" in reply to the June 14, 1976 Memorandum in Response to Motion from Whitman & Ransom and Marcus & Angel, attorneys for the trustee. The crux of the matter, in the hyperbole of the Reply Memorandum, is the so-called "wicked lie," plainly placing before the Bankruptcy Court the conflict of interest question:

"... the wicked lie that the Trustee himself concluded that a conflict exists is repeated though the Trustee's letter to this Court dated May 17, 1976 specifically states that this allegation is untrue and the Wisehart firm has been advised on numerous occasions that this statement is untrue. Nevertheless the Wisehart firm willfully, deliberately and clearly maliciously continues to repeat this falsehood. So that there can be no doubt now or in the future, the Trustee absolutely denies that he ever believed he had a conflict of interest in acting as Trustee of this bankrupt, denies that he presently believes that any such

conflict exists and denies that he ever stated that he either had or believed he had any such conflict. Moreover, the Trustee has been advised by his general counsel that he has never had any such conflict. We can only hope that this absolutely irresponsible contention will not be repeated in the future."

The attack in the Reply Memorandum, which was made with full knowledge of the trustee, centered around whether or not the trustee had ever "stated that he either had or believed he had" a conflict of interest. The "wicked lie" charge was not merely an unprofessional personal attack; it conveyed to the Court, on behalf of the trustee, with his knowledge, a false and misleading statement of what the true facts are, as shown by the following testimony by the trustee, months later, on December 15, 1976, before the Bankruptcy Court, on the trustee's motion to disqualify this firm (Tr. Dec. 15, 1976, p. 99).

Q You said words to this effect, "I have a conflict, too;" is that correct?

A [The Trustee] I said yes, I have a conflict too. Somebody, I think Mr. Devlin, he said, "Is this serious?" I said, "Yes, of course it is serious. I wouldn't have raised it --"

THE JUDGE: Just so I don't have to interpret words, when you said "I have a conflict," did you mean there was a possibility you had a conflict and you wanted some advice on it?

MR. FRIOU: Your Honor, I must object to the court leading the witness.

THE JUDGE: I am not trying to lead the witness. I am trying to get an understanding what he is testifying to.

A Mr. Friou knew exactly what my position was.

THE JUDGE: You just testified. You said you had a conflict.

A At the meeting March 9th, I opened the statement there by saying, "I have a conflict too." I set out the details of the relationship of the railroad department, of Shearson Hayden Stone doing consulting work for the railroads, in Mr. Friou's presence. I was asking pretty clearly, not telling you and the various lawyers present that I had a question.

A When you say "you," are you referring to the court?

THE JUDGE: Let him finish the statement.

A I presented to the judge, to all the lawyers present, some facts which I felt raised the question of conflict and I did it in the words which I agree, you tell me now are inartistic.

I said I have a conflict too. I said it at that time. I used the same language with Mr. Devlin and Mr. Nogg, "I have a conflict too."

Although we do not agree with the self-serving statements of the trustee in which he seeks to color what he actually said by his state of mind,

what is now admitted by him amply demonstrates, it is submitted, the extent to which the trustee permitted his attorneys, who were themselves involved in the same railroad-connected conflict of interest problem, to use misleading as well as excessively partisan statements in dealing with this issue.

Phrases used by them in the Reply Memorandum include:

"wicked lie"

"wild speculation and phantoms"

"new world's record in the domain of the hypocritical and the fantastic"

"fantasies"

"dreams and fantasies" (Reply Memorandum pp. 1, 3, 6, 7).

On June 29, 1976, Wisehart, Friou & Koch moved to strike the Reply Memorandum pursuant to Fed. Civ. Proc. 12(f) on the grounds that it contains impertinent or scandalous matter. Supporting affidavits were furnished by Robert J. Devlin and F. Ralph Nogg to the effect that the trustee had more than once said to them that he had a conflict of interest.

The return date of the motion was during the hearing on the Alltrans, REAEMCO and other proposals. The credibility of the trustee, as well as his qualification to favor the liquidation approach embodied in the

Alltrans proposal were in issue. The following colloquy took place as the Court declined to act on the Motion to Strike:

MR. WISEHART: Mr. Kahn reminded me this morning that a motion to strike is also on regarding certain statements and counsel in this case and whether they did or did not say something that was a wicked or evil lie.

All of the people who heard these statements are in this courtroom now. If that motion is going to be contested, then I want testimony.

THE JUDGE: They relates to a previous proceeding. I didn't read any of the scandalous statements if they were scandalous.

It no way affected my ruling in connection with the appointment of that law firm. I don't think that anything is to be gained.

I have not read them.

MR. WISEHART: There is a question that was not brought out in the context of this hearing and that is that a statement was made concerning the possibility of trustee conflict of interest.

THE JUDGE: I will not get into that and confuse the record with that issue. If there is any vitality to that motion to strike, I will deal with it later. It will not interfere with the hearing.

MR. WISEHART: The witness that we would rely upon in connection with that motion is here and present and offer them and make an offer of proof that they will testify as indicated herein.

THE JUDGE: That will not intrude upon this hearing. I think it will be confusing the issue and possibly inflammatory. (Transcript of July 9, 1976 at pp. 83, 84 and 85).

The Motion to Strike has never been acted on by the Bankruptcy Court. Trustee's counsel sought to withdraw the Reply Memorandum at the argument before Judge Werker. (Transcript of August 24, 1976 before Judge Werker at 25).

At the argument before Judge Werker on August 24, 1976, counsel for the trustee said that in February of 1976 the trustee had ascertained the fact of Shearson's railroad consulting work and further, counsel said:

"The trustee then went to Judge Galgay and said to the Judge, "I am concerned because this has just arisen and I seek the Court's guidance and counsel's guidance."

"Judge Galgay said, 'I see no problem with it, but I think you should file an affidavit.'" Transcript of August 24, 1976 before Judge Werker at 18.

Mr. Friou argued before Judge Werker that the conflict question affected the credibility of the trustee and the qualification of the trustee (Tr. 8/24/76 at 13), and was fundamental to the authority of the trustee to act on the disposition of the rights. (Tr. 8/24/76 at 15).

g. On July 16, 1976, the Bankruptcy Court approved the trustee's recommendation to sell REA's operating rights to Alltrans Express, U.S.A., Inc., and an appeal was taken by the employees' company, REAEMCO, Inc. The record designation contained material on conflict of interest and the trustee moved to strike such material from the record. Mr. Friou's affidavit dated August 17, 1976, in opposition to the motion he said, referring to the Windels & Marx opinion which we had not seen:

"Such an opinion of counsel is really not the matter that will place this question at rest. A judicial determination is required based upon a full evidentiary hearing with the full protection of the law." (p. 7).

h. By letter dated July 30, 1976, Windels & Marx, without first having verified any facts with Wisehart, Friou & Koch and entirely on the basis of the Trustee's oral statements to them, wrote to the trustee advising him that in their view there was not a conflict of interest which should cause him to resign, or alternatively it was too late or would cause too much harm to do so.

i. No copy of the Windels & Marx letter was furnished to Wisehart, Friou & Koch until after August 18, 1976. On the latter date during a hearing referred to above before the Bankruptcy Court, on the trustee's motion to strike conflict material from the appeal record to Judge Werker, the following colloquy took place:

THE JUDGE: Well, I have already indicated that I have received the opinion of Windels & Marx.

I am studying it. I have not written an opinion on it, I have not resolved that problem.

MR. FRIOU: Certainly that cannot - respectfully - your honor - the question cannot be resolved by a court without a hearing.

THE JUDGE: I would think that maybe in - that may be in order, but I haven't even studied the problem to that point. Transcript of August 18, 1976 at 30.

j. The opinion given to the trustee by Windels & Marx on July 30, 1976, which found no conflict of interest, was written without any prior questioning of

Mr. Wisehart or Mr. Friou and it contains multiple misstatements of fact. These factual errors are commented on in Mr. Friou's affidavit dated August 23, 1976, which was filed with Judge Werker and which is included as Document 7 in Appendix to Petitioner's Pre-Hearing Memorandum in this record.

However, not only is the Windels & Marx letter deficient factually - it is also completely in error on the law as we shall demonstrate below.

4. The Erroneous Report and Finding of the Bankruptcy Court on Conflict of Interest

In view of the foregoing catalogue of procedural steps taken on the conflict of interest question, one is astonished to read in the report and findings prepared by the trustee's counsel for the Bankruptcy Court to make to the Court, dated September 28, 1976 that:

"At such hearing of September 27, 1976, I ruled that there is no issue presently before this Court with respect to whether or not any conflict of interest exists on behalf of the Trustee or his counsel for the reason that no written motion to remove the Trustee has ever been filed with this or any other court nor has any notice of such a motion ever been sent to creditors, nor has any hearing date ever been set for such a written motion as required by Section 2a(17) of the Bankruptcy Act (11 U.S.C. § 11). I therefore excluded from my consideration and I exclude from this record all references and documents which attempt to raise or make any references or inferences with

respect to any issues of conflict of interest by the Trustee and in particular I exclude items 4, 5, 6, 7, 9 and so much of item 8 as discusses any such conflict from the list of documents in the appendix to the petitioner's pre-hearing memorandum."

The Bankruptcy Court further made the following finding of fact (No. 32):

"That the issue of conflict of interest sought to be raised by the petitioners against the Trustee and his counsel has not properly been raised before this Court, or any other court and is therefore not before this Court."

The foregoing report and findings we submit are completely erroneous. Plainly, the conflict issue was before the Bankruptcy Court - brought there by a number of substantial procedural steps as outlined above. And equally clearly the Court had said he had the question before him.

But there is also the error of treating the conflict of interest question as relating solely to the matter of removal of the trustee on a motion under Section 2a(17) of the Bankruptcy Act whereas the conflict taints the entire proceeding, every decision of the trustee, leads to special disqualifications as in this Chapter X proceeding, and has caused the role of the Bankruptcy Judge in this proceeding to be too narrowly perceived.

5. The Facts Pertaining to Trustee's Conflict of Interest

The pertinent facts on conflict of interest are set out in the following documents included in the "Appendix to Petitioner's Pre-Hearing Memorandum" filed in the Bankruptcy Court on September 27, 1976:

"4. Opinion of Mr. Friou to Mr. Sowerwine dated May 6, 1976.

5. Opinion of Mr. Friou to Mr. Sowerwine dated May 11, 1976.

6. Memorandum dated June 14, 1976 in response to motion for authority to retain Windels & Marx and requesting a hearing on the issue of conflict of interest.

7. Affidavit of Mr. Friou dated August 23, 1976, as submitted to Judge Werker on appeal, and discussing factual discrepancies of Windels & Marx opinion.

8. Appellant's Memorandum dated August 24, 1976 submitted in support of appeal from Bankruptcy Court. See pp. 65-74 for review of conflict of interest cases.

9. Affidavit of Mr. Larsen dated May 30, 1975 showing liquidation of approach of railroads."

For the convenience of the court for general background we here excerpt from pages 4 to 7 of Appellant's Memorandum Document No. 8 in the Appendix to Petitioner's Pre-Hearing Memorandum:

"REA is the historic express company with antecedents dating back more than 150 years. From 1929 through August 1969, REA was owned by the railroads. In 1969, REA was sold by the railroads to a group headed by a new management team which the railroads had recruited. In 1968, the railroads put REA in a voting trust for the purpose of its disposition with a non-existent net worth.

In 1959, the railroads originally decided it would be desirable, from their point of view, to liquidate REA. They were deterred from this course of conduct, however, when Booz, Allen & Hamilton, a management consulting firm, advised them confidentially that the liquidation of REA at that time would be imprudent in view of the massive liabilities which the railroads would incur inter alia because of the claims of the employees of REA who would be thrown out of work. Instead of liquidating REA then, the railroads decided to alter the contractual arrangements, hopefully absolving them of REA's liabilities, and embarked upon a course of conduct which resulted in slowly draining off REA's assets over the years, until they finally sold it in 1969 in a depleted, shrunken condition. In 1959, REA had over 40,000 employees; by 1969 the number was reduced to less than half, and at the time REA was adjudicated a bankrupt, there were only approximately 8,000 employees left. The foregoing information is derived from the public record in the "Notes" case currently pending simultaneously in the Second Circuit Court of Appeals and in a three-judge court in the Southern District comprised of Judges Friendly, Griesa, and Knapp, sub nom. C. Orvis Sowerwine, Trustee, REA Express, Inc., v. Alabama Great Southern Railroad Company, et al., D.C. Dkt. No. 71-4278 and 2d Cir. Dkts. 75-4209 and 76-4103. More

particularly, the above information is based upon the affidavit of A. Ernest Larsen in that case which has also been made a part of the record herein.

The Notes case involves approximately \$27 million of REA's notes held by its former railroad owners, which they seek to enforce. It is REA's position that the notes are null and void, that they were issued without consideration and in violation of Section 10 of the Clayton Act and other antitrust laws, that they and the interest paid thereon constituted fraudulent conveyances in relation to REA's creditors, and that said interest and other resulting damages should be paid to REA.*

The employees remaining at the time of REA's adjudication, of course, were the most senior employees. Their average age was in excess of 50 years, and opportunities for other suitable employment were extremely limited.

REA finally petitioned for reorganization under Chapter XI of the Bankruptcy Act on February 18, 1975. It operated as a "debtor-in-possession" until it was adjudicated a bankrupt on November 6, 1975. During that period, REA's former management was in control of the company.

While REA was being operated as a debtor-in-possession, a committee of creditors was formed at a first meeting of the creditors on April 8, 1975, in the Bankruptcy Court. The members of the Creditors' Committee were nominated at that time: of 11 members, six were airlines and one was a railroad, the Penn Central. (The Penn Central was also on the three-member Executive Committee.)

*On November 18, 1976, a three-judge court denied REA's request to invalidate the decision of the Interstate Commerce Commission under which the notes were issued. S.D.N.Y. Dkt. No. 71 Civ. 4278. A notice of appeal has been filed.

Although these carriers were ostensibly creditors of REA, they were also parties in proceedings in which REA had substantially larger claims against them than their claims against REA. Further, the Creditors' Committee itself had been nominated by railroad interests as had the "standby Trustee", Mr. C. Orvis Sowerwine. Later, it developed that the firm in which Mr. Sowerwine is a Senior Vice President, Shearson Hayden Stone, is also actively involved in railroad financial interests.

Counsel to the Creditors' Committee were firms representing railroad interests who had nominated Mr. Sowerwine. Later, it became apparent that their railroad involvement was much more extensive than originally supposed.

When REA was adjudicated a bankrupt on November 6, 1975, Mr. Sowerwine became Trustee one day later, on November 7, 1975, and selected the counsel who previously had nominated him as "standby Trustee" to be bankruptcy counsel. No notice was given to the creditors or hearing held as to the qualifications of Mr. Sowerwine or bankruptcy counsel. Indeed, from November 6, 1975 to present, no meeting of the creditors has been called. Instead, the Trustee and his counsel immediately declared that their purpose was to liquidate REA. No effort was made to ascertain the desires of the creditors with respect to this decision, nor was there any hearing on the possibility of reorganization."

6. Discussion of the Applicable Law

The conflict of interest doctrines which have developed are for the preservation of the integrity of the

judicial process, and are not for its incapacitation. But it is the latter condition that has resulted from the failure of the Bankruptcy Court in this proceeding to act upon the conflict of interest question as it pertains to the entire process of this proceeding. The efforts of bankruptcy counsel for the trustee to force the conflict of interest question into the narrow confines of a motion to remove the trustee has been accepted erroneously by the Bankruptcy Court when the court states on page 3 of its report: "I rule there is no issue presently before this court with respect to whether or not any conflict of interest exists on behalf of the trustee or his counsel for the reason that no written motion to remove the trustee has ever been filed with this court or any other court." This narrow view of the conflict of interest question is totally incorrect. The key motion made before the Bankruptcy Court on the record on September 27, 1976 was not a motion to remove the trustee, but a motion to disqualify him and his counsel from acting and appearing on behalf of the bankrupt estate in Chapter X proceedings. See In re Freeport Italian Bakery, Inc., 340 F.2d 50, 55 (2d Cir. 1965); Meredith v. Thralls, 144 F.2d 473 (2d Cir. 1944), cert. den. 65 S. Ct. 92.

The action of the Bankruptcy Court, expressed not only in its report and findings of September 28, 1976, but

throughout the bankruptcy, seems plainly out of tune with recent rulings of this court. In a recent decision the Second Circuit admonished a District Judge to decide conflict issues initially when the possibility of such a conflict arises.

U.S. v. Carrigan, F.2d, summarized in the New York Law Journal for November 8, 1976, page 1. While that case arose in the context of Sixth Amendment Rights, we can see no reason in principle to distinguish that from the all important function of a trustee in a bankruptcy case. No. 12 of the A.B.A. Canons of Judicial Ethics specifies that trustee appointed by a judge "should have the strictest probity and impartiality." We submit that this is a continuing responsibility which the Bankruptcy Court must exercise, regardless of the form in which the possibility of a conflict on the part of a trustee is brought to its attention. This continuing responsibility is especially important when, as in this case, the Trustee has been selected by large creditor interests who themselves are subject to a substantial conflict because of the size of REA's claims against them.

Further, as the Second Circuit said, in reversing and directing removal of a trustee forthwith, "If the administration of the estate in bankruptcy would suffer more from the discord created from the present trustee than would be

suffered from a change in administration, the removal of the trustee is necessarily the better solution." In re Freeport Italian Bakery, Inc., 340 F.2d 50, 55 (2d Cir. 1965).

As the Second Circuit said In re Haupt & Co., 398 F.2d 607, 612 (2d Cir. 1968):

"A referee in bankruptcy is not simply an umpire calling balls and strikes. He has an affirmative responsibility for the proper handling of the estate, and that is not always discharged merely by ruling on papers the parties have presented to him. Cf. In re Prindible, 115 F.2d 21, 24-25 (3d Cir. 1940); 2 Collier, Bankruptcy ¶ 30.03. Particularly in light of his knowledge of the acerbities that had unfortunately characterized the relationship of the Trustee and Mr. Freund from the beginning, see In re Ira Haupt & Co. (Knapp v. Seligson), 361 F.2d 164 (2d Cir. 1966), and prevented any meaningful dialogue between them, it was incumbent on the Referee to see that these personal difficulties did not work detriment to the estate or the bankrupt.

The Referee should thus have considered the application as raising again the entire question of the proper handling of the claims, which had come before him on the Trustee's application for instructions in February 1965 but had never been resolved."

The Trustee here involved seeks to avoid the appearance of discord by having failed to call a meeting of creditors

since adjudication on November 6, 1975. We believe that this is contrary to the Bankruptcy Rules, an issue also on appeal. The importance of that issue is accentuated by the Second Circuit's recent ruling that "It is axiomatic ... that a self-dealing trustee owes a duty of full disclosure to the beneficiary of this trust." Galfand v. Chestnut Corporation, 54 F.2d, reported in N.Y.L.J. Nov. 19, 1976. In other words, the law properly puts the initial burden upon the fiduciary, not upon his beneficiaries.

We have contended that disclosure is the obligation of the Trustee here. His beneficiaries are the creditors. The Bankruptcy Act contemplates that all creditors will be permitted to participate intelligently in the administration of a bankrupt estate. But that cannot happen if the Trustee fails to call the meetings required by law, and refuses to disclose to them the conflict of interest problems of himself and his counsel.

Mr. Justice Jackson aptly said in Mosser v. Darrow, 341 U.S. 267, 271 (1951):

"Equity tolerates in bankruptcy trustees no interest adverse to the trust. This is not because such interests are always corrupt but because they are always corrupting. By its exclusion of the trustee from any personal interest, it seeks to

avoid such delicate inquiries as we have here into the conduct of its own appointees by exacting from them forbearance of all opportunities to advance self-interest that might bring the disinterestedness of their administration into question."

Meredith, et al. v. Thralls, 144 F.2d 473 (2d Cir.

1944), squarely in point in the REA situation, is not cited by Windels & Marx in their July 30, 1976 letter to the trustee. In that case the district judge in a Chapter X reorganization appointed two clearly disinterested trustees and Mr. Thralls, who was a director of the debtor, as an "additional" trustee. There was no question as to the ability or integrity of Mr. Thralls.

The court pointed out that Mr. Thralls was an employee of the Reconstruction Finance Corporation which through another corporation owned all the stock of the debtor. It also appeared that the debtor had, and was likely to continue to have, business dealings with a number of companies in all of which the Reconstruction Finance Corporation was heavily interested. The court said that Mr. Thralls as an employee of RFC and as a trustee of the debtor necessarily would be under a cross-file of conflicting loyalties. Mr. Thralls said that if a situation arose he would report it to the court and leave determination of that particular question to his co-trustees. The district

court and the Circuit Court had complete confidence in Mr. Thralls' integrity, but the Circuit Court said that the objection to having a trustee with dual interests cannot be waived merely because the integrity of the particular individual makes it unlikely that harm will result.

Judge Learned Hand dissented, but on the grounds that a distinction could be made between "operating" trustees and those having general control over the reorganization. The district judge had said that Mr. Thralls' services as an operating trustee only were desirable. Such limited service Judge Hand approved; but, in the context of the Thralls case where there were two other clearly disinterested trustees, this is not disturbing to the general rule of disqualification. The view of the Circuit Court in Thralls case plainly applies in the REA situation.

Thralls is most pertinent in that it shows that the appointment of Mr. Wright does not insulate the Trustee or cure the problem with respect to REA's major litigation; and certainly the appointment of Mr. Wright has no bearing upon the disqualification of the trustee as to his position on the Chapter X petition nor does such appointment clear the trustee on the matter of valuation of claims - a duty imposed by Bankruptcy Act § 47(8).

To that effect the Second Circuit said in Thralls:

"As the representative of the latter [RFC] and as additional trustee of the debtor, Mr. Thralls will necessarily be under a cross-file of conflicting loyalties in any such transaction. He testified that if such a situation should arise, he would report it to the court and leave determination of the question to his co-trustees, as he had done in the past in his capacity as a director. The district judge has complete confidence in the integrity of Mr. Thralls and so have we. But if we are right in construing the statute to forbid the appointment of a person having such dual interests, the objection cannot be waived because the integrity of the particular individual makes it unlikely that harm will result. We are of the opinion that the appointment was unauthorized." (144 F.2d 473, 475) (Emphasis added.)

The concern of the court in Thralls was with Bankruptcy Act § 156, 11 U.S.C. § 556, which provided in relevant part:

"Any trustee appointed under this chapter shall be disinterested and shall have the qualifications prescribed in section 45 of this Act, ..."

Section 45 of the Bankruptcy Act (11 U.S.C. § 73) does not itself comment on adverse interest but Bankruptcy Rule 209 revised § 45 by adding the qualification that the trustee have no interest adverse to the estate. See Rule 209(d) and the Advisory Committee's Notes thereto. Those Notes state:

"The requirement of the first sentence of subdivision (d) that the trustee have no interest adverse to the estate has been developed by case law."

Thus the conflict issue goes to the statutory authority of the trustee.

The cases cited by Windels & Marx on the conflict of interest question are simply not especially pertinent to the REA situation.

Windels & Marx cite only three cases where courts have approved the selection of a trustee notwithstanding allegations of conflict of interest.

The first case cited is a 1924 decision by a California Federal District Court (In re Foley (D.C. S.D. Cal. N.D.) 1 F.2d 568), a case so old and far removed that plainly it does not deserve citation as a leading authority here. There the trustee was an employee of Bank A in Los Angeles, the stockholders of which owned Bank B, the creditor. It appeared that:

1. The trustee, upon appointment, immediately resigned from Bank A with no understanding or arrangement to return. Distinctively, the REA trustee has retained his employment, his office and his secretary at Shearson Hayden Stone and regularly worked at that office, so that the REA

trusteeship was only a part-time job. Now (very recently) he says he has taken leave of absence from Shearson Hayden Stone, but has kept his office and secretary and works there without salary. (Transcript of December 15, 1976 at 86, 87, 88, 89). Recently he has been working "half and half" between REA and Shearson - about 15 or 20 hours a week for Shearson. Transcript of December 16, 1976 at 3. If a pending corporate financing he is working on closes December 30, 1976, he may go back on the payroll, or get a bonus from Shearson. Transcript of December 16, 1976 at 5. He has retained board of director memberships in some corporations, the same resulting from his affiliation with Shearson or its predecessor. Transcript of December 16, 1976 at 5.

2. The Foley Trustee immediately sued Bank B, thus contesting its claim. We do not agree with the California District Court that such action necessarily was ameliorative; but, no matter, the REA trustee did not disallow the claims of railroad and airlines, he did not assert against those claims the pendency of even larger REA claims (against airlines) or defenses arising out of lawsuits (against railroads), he did not even suggest to those creditors that he had defenses arising out of the major litigation. By complete contrast, the REA trustee is, however, contesting employee claims for pay reductions and lost holidays and vacations.

The second authority cited by Windels & Marx to show court approval of trustees where conflict is alleged is equally supportive of our view: In re Paramount Publix Corp., 68 F.2d 703 (C.A. 2d Cir. 1934), cert. denied, 292 U.S. 652. This case involved three trustees appointed, as was the REA Trustee, with no more than merely formal approval by the referee. The Second Circuit held that this was improper and did not show exercise of a sound discretion.

However, on procedural grounds the Court reviewed the merits:

1. Hilles, upon appointment as trustee, "immediately" resigned as a director of Bankers Trust Co., and he sued Bankers Trust and other banks for alleged preferences in large payments before bankruptcy. The court noted that his past friendly business contacts were not disqualifying.

2. Leake, "immediately" upon appointment resigned as Chairman of the Board of Directors of American Express and resigned as president and director of Film Securities Corporation.

3. Richardson, "immediately" upon his appointment as trustee resigned as vice president and treasurer of Fox Film Corporation.

The court noted that two of the trustees had experience, and intimate knowledge, of the motion picture industry. It is undisputed in the REA case that the Trustee has no experience in the transportation industry.

One may wonder at why the Paramount Publix case was cited by Windels & Marx; the fact is it furnishes strong support for our assertion that the REA Trustee is disqualifed.

Furthermore, we do not understand why Windels & Marx have cited In re Eloise Curtis, 261 F. Supp. 325 (S.D.N.Y. 1966), aff'd, 388 F.2d 416 (C.A. 2d Cir. 1967). That case involved a trustee who, having been elected by the creditors, was removed because of misconduct in his prior appointment as assignee for the benefit of creditors.

Windels & Marx states the proposition that the appointment of Mr. Wright "... effectively excised the problem of the litigations against the creditor-defendant railroads" We do not agree with the proposition nor do we find any relevance in the cases cited for the proposition.

The first case, In re National Public Service Corporation (C.C.A.2d 1934), 68 F.2d 859, involved the appointment of a single trustee to compromise claims involving four bankrupt corporations. The complaining creditor complained to the trustee (and its attorneys) soon after its election and asked them to resign. They refused and the complainant then worked actively with them through the entire administration without further complaint, and without bringing the matter to the referee's or the court's attention, until a complete settlement was finally reached and the creditors notified of a meeting to confirm. When that settlement was presented to the creditors, the complainants finally moved to remove the trustee and his

attorneys. They alleged no misconduct, no irregularity, no unfairness resulting from the alleged conflict. The court said:

"They [the banks] had no separate business to operate, and, do what one might to divide them, their affairs were not divisible. Therefore the answer [need to have separate administrations] seems to us in the end rather doubtful though it would perhaps be hard to deny the demand of a creditor, who had insisted in season and in good faith that the estates should be separately administered. At any rate, we shall assume arguendo that he would succeed." 68 F.2d 859, 863.

"Other creditors may be entitled to ask us to do this, but we are not disposed to hear that complaint in the mouths of these appellants." 68 F.2d 859, 863.

How different the National Public Service facts are from the case of the REA Trustee and his counsel:

1. Immediately upon adjudication, the conflict of interest of Trustee's counsel was brought to the attention of the Bankruptcy Judge in personal conference by a member of this firm.

2. The Cinema 5 decision of the Second Circuit Court of Appeals and its dispositive relevance to REA was brought to the attention of the Trustee and his counsel in January 1976, by a member of this firm, as a basis for disqualification of such counsel.

3. The subject was again brought before the Bankruptcy Court in February 1976, by means of a comprehensive written presentation by this law firm.

4. There followed on March 9, 1976, a conference with the Bankruptcy Judge attended by all counsel and the Trustee. The colloquy, discussed elsewhere, was in part off the record (although we asked that it be on the record) but it recognized the existence of a conflict on the part of Trustee's counsel. The Trustee now testifies that he also informed the court at that conference that he "had a conflict too." Transcript of November 10, 1976 at 79.

5. At the Trustee's request on April 13, we gave him, in early May, 1976, two strong opinions to the effect that he had a conflict of interest and should resign as Trustee.

6. By a letter dated May 17, 1976 (which we did not receive until August 23, 1976), the Trustee advised the Bankruptcy Court of his receipt of our opinions.

7. In a substantial memorandum to the Bankruptcy Court, dated June 14, 1976 (Appendix Doc. 12, pp. 89-103), this firm again raised the problem of conflict of interest and recommended that a hearing be held on notice to creditors before a U.S. Magistrate.

Thus, National Public Service impels the conclusion, a fortiori, that the REA Trustee and his counsel are disqualified, and it plainly does not support the Windels & Marx conclusion.

The second citation for this proposition is the first Second Circuit opinion in In re Eloise Curtis, 326 F.2d 698 (2d Cir. 1964), which merely holds that the referee below had erred in ruling that as a matter of law an assignee for the benefit of creditors is disqualified, ipso facto, to be a trustee. After a hearing, on remand, the removal was reconfirmed, but for cause, and the removal was later approved by the Court of Appeals as we have noted above. In re Eloise Curtis, 388 F.2d 325.

Finally, In re G.E.C. Securities, Inc., 331 F.2d 655, 565 (2d Cir. 1964), aff'd, 223 F. Supp. 861 (D.C. S.D.N.Y. 1963), is cited by the Windels firm as authority for excision of conflict by appointment of special counsel. In that case, however, it appears that while a small area of conflict may have existed, the referee had stated that "... it was most improbable that a conflict of interest, in fact, did exist" The district judge held the referee's approval of the trustee to be a finding of fact and his views were upheld on appeal. There is no similar finding in the REA case.

III

THE CONFLICT ISSUE HAS DIRECT BEARING
UPON THE PRO-LIQUIDATION POSTURE OF THE TRUSTEE

The conflict issue in this case is not simply a question of legal niceties. It is not disputed that since 1959 the former railroad owners have sought to engineer REA's liquidation, in large part to escape from liabilities to former employees like those who are appellants here, and in part to clear the way for the establishment of their own trucking and air freight forwarding subsidiaries. Major litigation with the railroads on their liquidation-motivated schemes directed at REA and other issues are pending. Meanwhile, the railroads have filed claims against the bankrupt estate of approximately \$40 million, substantially all of which are disputed.

The airlines were also active competitors with REA and sought to establish their own premium expedited services on the ashes of REA's Air Express operation. Further, although the airlines also purport to be creditors, REA has claims against them substantially exceeding their total claims against REA.

To neither the railroads nor the airlines would the prospect of a reorganized REA have appeal.

Thus, perhaps the key purported "finding" in those

prepared by the Trustee's lawyers for Judge Galgay's signature in dismissing the Chapter X petition is the following:

"30) That the liquidation being conducted by this Trustee is the best method of preserving the remaining values for those entitled to share in such values."

Not one scintilla of evidence in the record supports that finding. Although extended offers of proof were made on behalf of the former employees, no testimony was offered by or for the Trustee. Thus the "clearly erroneous" rule has no application.

The only thing in the record which might support the finding is a wholly improper document entitled "Answer of Debtor" which the Trustee wrongfully procured from a former REA employee dependent upon him for continuing support, using his attorney from Whitman & Ransom as a notary, and another attorney with a conflict of interest who now seeks to withdraw from the matter but whose request to do so has remained unacted upon by the Bankruptcy Court. A copy of the purported Answer is submitted herewith as Appendix B. A motion to strike has been made and we submit that it should be regarded as withdrawn and without effect.

The prejudicial activities of the Trustee also included an attempt to suppress reports to him by transportation

executives who were former officers of REA casting serious doubt upon the assertion that the liquidation being conducted is in the best interest of the estate. The report of Mr. Miller dated March 25, 1976 is submitted herewith as Exhibit C.

The Trustee himself had a direct financial self-interest in avoiding displacement through an attempted reorganization with an operating trustee competent in transportation matters.

The disastrous consequences for the bankrupt estate of the Trustee's liquidation policy are readily apparent in the ICC's Report and Order of November 17, 1976 with its findings regarding the incompetent and illegal manner of operation by the Trustee, and reference to the fact that REA is in bankruptcy and liquidation.

Yet these consequences of the Trustee's liquidation approach were plainly predicted by Mr. Nogg, in recommending that the bankruptcy be converted to a Chapter X reorganization so that the same techniques he had applied successfully in reorganizing Yale Express would be available.

Tr. June 24, 1976, pages 127-128:

Q. Mr. Nogg, you testified earlier that you had advised the trustee that in your view to preserve the authorities that REA has for the benefit of the creditors this should be treated as a reorganization proceeding; is that correct?

A. Yes, that's correct.

Q. Is that still your view?

A. Yes, indeed.

Q. Is that your view particularly in view of the jeopardy in which REA authorities have been placed by this current proceeding?

A. Yes. I recited this and had quite a conversation with the honorable trustee how the storm forces would gather no matter who stepped in. He had a conversation previous to mine and was very well apprised. He knew about the situation.

THE JUDGE: I don't understand what you mean by your question and the answer, are you suggesting that it be taken out of the straight bankruptcy liquidation and moved into a Chapter X?

MR. WISEHART: Yes, Your Honor.

As a matter of fact that is the bottom line to preserve the authority and we have a petition for that purpose, which we now intend to present to the court.

I would ask that it be marked for identification as REAMCO Exhibit 25. It is my understanding that the court may entertain this in its

discretion and it is the position of REAMCO and Mr. Nogg that this is the step best calculated to preserve the authority which REA has.

THE JUDGE: You may have it marked for identification. I will not see it for the moment.

(Document marked REAMCO
Exhibit 25 for identification as of this date.)

MR. WISEHART: That concludes my direct examination of Mr. Nogg.

THE JUDGE: REAMCO Exhibit 25 for identification is an application to transfer these proceedings into a Chapter X proceeding.

Further, on November 17, 1976, Mr. Nogg testified as follows:

"I told him [Mr. Sowerwine, in December 1975] definitely I was in favor of a Chapter X, because I felt that unless the operating authority were continued the greatest asset of REA would be placed in serious jeopardy"

"From that time on that has been my stand. I have not deviated one iota from that." (p. 43)

"... I very strongly suggested the Chapter X because of the danger of the operating authority being placed in jeopardy." (p. 72)

At the meeting with the Trustee on April 19, 1976, "... I again reiterated my original stand that they were going to bump into trouble unless they continue the operation in the name of REA and the transfer of authority would be almonst impossible."

"It would take so long that the authority could well be dead, and that is why I have always recommended a Chapter X on going business."
(Tr. 74)

Other references to such discussions by Mr. Nogg are at pages 47, 72, 75 of the transcript of the hearing on November 17, 1976.

IV

THE TRUSTEE HAS FAILED TO COMPLY
WITH THE REQUIREMENT THAT HE MUST HEED
THE CREDITORS IN THE ADMINISTRATION OF
BANKRUPT ESTATE

We will not here repeat the point previously discussed concerning the trustee's obligation, in our view, to inform the creditors regarding the conflict of interest problem. The discussion here is devoted to the more general point that, having failed to permit the creditors to participate in the administration of the bankrupt estate in the manner required by law, the trustee's position that the liquidation being conducted by him "is the best method of preserving the remaining values for those entitled to share in such values" was ultra vires.

It is undisputed that, since adjudication, there has been no meeting of creditors whatsoever since adjudication. However, Bankruptcy Rule 204 specifically states that "The first meeting of creditors shall be held not less than 10 nor more than 30 days after adjudication...." subject to certain exceptions not material. The Advisory Committee's note states that the trustee has the responsibility for taking the steps pertinent and necessary to promote the best interests of the

estate "and the enforcement of the Act", and further provides that he "should give heed to the wishes of creditors".

One of the provisions of the Act which the trustee has the duty of taking the steps necessary to enforce is the requirement of Section 44 that there shall be a first meeting of creditors after adjudication. One of the important functions of such a meeting is to appoint a trustee. Section 44 a of the Bankruptcy Act in its entirety provides (11 U.S.C. § 72):

"...The creditors of a bankrupt, exclusive of the bankrupt's relatives or, where the bankrupt is a corporation, exclusive of its stockholders or members, its officers, and the members of its board of directors or trustees or of other similar controlling bodies, shall, at the first meeting of creditors after the adjudication, or after a vacancy has occurred in the office of trustee, or after an estate has been reopened, appoint a trustee or three trustees of such estate. If the creditors do not appoint a trustee or if the trustee so appointed fails to qualify as herein provided, the court shall make the appointment. If the bankrupt is a face-amount certificate company, as defined in section 4 of the Investment Company Act of 1940- the court alone shall make the appointment; but the court shall not make such appointment without first notifying the Securities and Exchange Commission and giving it an opportunity to be heard"

The trustee has previously argued that compliance with the foregoing provision is not required because on April 8, 1975, seven months before REA's adjudication on November 6, 1975, Mr. Sowerwine was elected a standby trustee.

But the main issue before that meeting was whether REA's former management should be permitted to continue in operation of the company as a debtor-in-possession. Mr. Sowerwine was not known to most of the creditors, was not even present at the meeting, certainly there was no knowledge about what he intended to do in the conduct of the business of the estate should there be an adjudication, and was not questioned about his qualifications. Everyone hoped that the business would continue, that the debtor-in-possession period would succeed. The debtor-in-possession, then at the mercy of the creditors, was in no position to object to Mr. Sowerwine as a "standby trustee," and the creditors -- chief among whom would be the former employees -- knew nothing about him or his qualifications. The issues were entirely different at the meeting of April 8, 1975, and it would be a perversion of the statutory scheme to say that that meeting sufficed for a first meeting of creditors following adjudication as required by the Bankruptcy Act. As pointed out above, a chief purpose of the first meeting after adjudication is to permit the creditors to pass on the proposed trustee in open hearing. This would require full disclosure to be made regarding his affiliations, plans and programs regarding the bankrupt estate. But, in this case, there has been no compliance with this requirement -- to the great prejudice of those creditors to whom such a hearing

would be most important -- the former employees. And certainly the court order appointing the trustee, one day after adjudication, on the basis of his representation that he had no conflicting or adverse interests could not be regarded as satisfying the statutory requirement.

The District Court's Bankruptcy Rule X-22 is consistent with the statutory requirement. While its applicability is to conversion to straight bankruptcy from Chapter X proceedings, it also refers to appointing "a receiver to replace the debtor in possession" -- which would be a Chapter XI as REA was in, and states that the order of adjudication must direct the Chapter X trustee to continue to administer the estate until Section 44 of the Bankruptcy Act has been complied with for the election of a trustee. As pointed out above, Section 44 specifically requires a first meeting of creditors following adjudication.

Most revealing is the following official note following the Rule X-22 because it bears directly upon the application for the appointment of a receiver here, indicating that that step was mandatory following REA's adjudication after being a "debtor in possession":

"NOTE: Identical to former Rule X-22. Note that under this rule if there is a trustee, the judge 'shall' direct him to continue to act until the bankruptcy trustee is elected. If the debtor was in possession, the judge 'shall' appoint a receiver

to serve until the bankruptcy trustee is elected. The Bankruptcy Act makes no provision for the interim between adjudication and the election of a bankruptcy trustee, and this rule is intended to fill the gap." (Emphasis added.)

The function of an independent receiver, with direct bearing upon this case is shown by local Bankruptcy Rule 8(c) which provides in principal part:

"The order appointing the receiver may authorize him to continue the business for a period of not more than fifteen days, during which time he shall inquire into the propriety of its further continuance, and if he decides that the business should be further continued he shall so petition the court setting forth his recommendations and the recommendations, if any, made by substantial creditor interests." (Emphasis added.)

We will not repeat here the further reasons for the appointment of a receiver which are set forth in the brief of Intervenor Brotherhood of Railway and Airline Clerks except to say that such action also would be most desirable in view of the Trustee's efforts to silence this firm both in this appeal and from having "equal time" on behalf of the employees who seek reorganization of REA in the Interstate Commerce Commission proceeding in which the "all or nothing" approach taken by the Trustee has had such disastrous results. The importance of an independent assessment regarding REA, its prospects, and remaining values, in such a sharply contested situation is clearly indicated by Protective Committee v. Anderson, 390 U.S. 414 (1968).

CONCLUSION

1. The question of conflict of interest was adequately raised procedurally so as to have placed the issue squarely before the bankruptcy court.

2. There was substantial evidence before the bankruptcy court on (a) conflict of interest and (b) self-interest in perpetuation in office to have caused the bankruptcy court to either (1) summarily disqualify the trustee and his counsel and appoint a receiver for purposes of the Chapter X petition, or (2) hold a hearing on those subjects and provide suitable relief.

3. The evidence, in fact, is sufficiently strong that the bankruptcy court should have scheduled a hearing on notice to creditors to determine whether the trustee and his counsel should be removed.

4. This court has, and should exercise, summary power to disqualify or remove the trustee.

5. The decision below should be reversed and the proceeding remanded with instructions to entertain the application for the appointment of an independent receiver forthwith.

Dated: New York, New York
December 23, 1976

Respectfully submitted,

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CERTIFICATE OF SERVICE

The foregoing Brief was served by mailing
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